

## **HEDGE FUNDS AND SHAREHOLDER ACTIVISM**

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**H**edge funds have been prominently featured in the news in the past years, whether in stories about their historically high returns, high fees, SEC registration requirement, or shareholder activism. It was not until the past year, however, that we witnessed the rise of hedge funds to the forefront of shareholder activism. It is not just the frequency of aggressive moves by hedge funds into corporate governance that has attracted attention, but the high rate of success they have had. In 2005, The Altman Group tracked 20 instances of shareholder activism involving hedge funds. In 15 of those cases the target company conceded or was forced to accept to some degree the demands of the dissident shareholder.

Hedge funds will continue to play an increasing role in the investment and shareholder activist community for some time to come. It is estimated that there are between 7,000 and 8,000 hedge funds worldwide. The SEC estimates total hedge fund assets in the US are now \$1 trillion, a 20 percent increase from 2004. It is estimated that by 2008 hedge fund assets may reach \$5 trillion.

As a result of this increased prominence, there are some major changes for hedge funds. Hedge fund advisors were required to register with the SEC as investment advisors by February 1, 2006. There is a loop-hole in the registration re-

quirement which allows hedge funds with a “lock-up” period of at least two years to avoid registering with the SEC. Although many hedge funds have registered, there are many hedge funds that are taking advantage of this loop-hole by extending their “lock-up” period.

In addition, there is a case before the D.C. Circuit Court of Appeals which is challenging another loop-hole to the hedge fund registration requirement. The case was brought by Opportunity Partners’ Phil Goldstein, who is known for his shareholder activism. The case argues that the SEC exceeded its authority when it classified individual investors in a fund, and not a fund itself, as “clients”. An advisor with less than 15 “clients” would not be required to register, but with the change virtually all hedge funds will need to register.

### **Demands of Hedge Funds**

**W**hat are hedge funds demanding of their target companies? The following is a summary of their possible demands:

1. The company sell itself, certain assets, or a business unit. Hedge funds prefer the auction process where the company can attract competing bids and be sold at the highest price, usually ensuring a

good return for the hedge fund.

2. Increase dividends.
3. A stock buyback to increase the share price.
4. Board seats. Hedge funds have one or two motives in seeking board seats from a company: (1) if the company is not responding to the fund's request for an immediate action (e.g., increasing the dividend or selling the company.); or, (2) to put their own directors on the board so they can have a long-term voice in the direction of the company. The board seat strategy a fund chooses could depend on whether the fund is investing in the company for the short- or long-term.
5. Corporate governance changes. For example, they may ask a company to put an independent director on the board, declassify the board of directors, or remove a shareholder rights plan (poison pill).

In the vast majority of cases, hedge funds are getting what they ask for from companies. Whether the company settles with the fund or the fund wins during a proxy fight, hedge funds are having their demands met.

Hedge funds have never made a secret of the fact that they generally invest in securities for the short-term. Hedge funds generally target companies where the stock price is significantly below the perceived or actual value of the company.

Companies with poor corporate governance practices are also targets of activist hedge funds.

### **Hedge Funds United**

**A**lmost all hedge funds generally have the same objective (and business strategy), which is to increase their returns on a short- and / or long-term basis. As a result, hedge funds will generally support each other's activism at a company, and when an issue comes to a shareholder vote they will generally vote in line with their hedge fund allies. Issuers should note that an investor can talk to ten additional shareholders without filing proxy materials with the SEC. However, multiple funds that are looking to work together to engage a corporation on the same issue will form a "temporary" fund. The "temporary" fund is a legal entity formed by multiple hedge funds to get around the SEC registration requirement.

Another interesting trend is that mainstream investors are beginning to join forces with the hedge funds, if only indirectly. Traditional institutional investors are directing some of their assets to more activist hedge funds. This is an indirect way for the traditional institutional investors to press a company's management to make changes. The largest U.S. pension fund, the California Public Employees' Retirement System (CalPERS), has increased its fund allocation to hedge funds to \$2 billion. It is estimated that institu

tions account for over half of all new capital inflows to hedge funds.

Corporations should be very aware of their shareholder base, what their demands are, and how they vote on issues that come to a shareholder vote. Communication with a corporate issuer's shareholders is an absolute necessity in today's environment.

**The Players**

The following table offers some examples of some of the most activist hedge funds and their corporate actions:

<b>Hedge Fund</b>	<b>Corporate Action</b>
Opportunity Partners	<ul style="list-style-type: none"> <li>• Forced Blair Corp to sell a business unit to Alliance Data Systems.</li> <li>• Offered to buy Wells Financial Corp. Wells turned the offer down but Opportunity Partners got enough shareholder support to cause the company to go through a Dutch auction self tender.</li> <li>• Pressured Airnet Systems to put itself up for sale.</li> </ul>
Steel Partners	<ul style="list-style-type: none"> <li>• Made a \$700 million hostile offer to buy GenCorp Inc. Other hedge funds (Gabelli Asset Management and Sandell Asset Management) also asked for changes at GenCorp. The pressure on GenCorp caused them to settle with the hedge funds, and among other things they added a corporate governance expert to their board of directors.</li> <li>• Sponsored a shareholder proposal at Layne Christensen Co. asking the company to repeal a classified board structure. The proposal passed.</li> <li>• Launched a successful proxy contest at BKF Capital seeking board seats.</li> </ul>

<b>Hedge Fund</b>	<b>Corporate Action</b>
Pirate Capital	<ul style="list-style-type: none"> <li>• Launched a contest against Cornell Companies but the contest was settled when Cornell agreed to put seven Pirate directors on the board.</li> <li>• Instrumental in attracting offers for John Q. Hammons Hotel.</li> <li>• Influential in the settlement at GenCorp.</li> <li>• Settled proxy fight with Cutter &amp; Buck after Cutter agreed to declassify the board and accelerate the expiration of its poison pill.</li> </ul>
Relational Investors	<ul style="list-style-type: none"> <li>• Called off a proxy contest with SPX after the company agreed to add an independent director.</li> <li>• Pressured the board of Sovereign Bancorp with regard to their decision to sell a portion of the company to Santander.</li> </ul>
Loeb Partners	<ul style="list-style-type: none"> <li>• Forced Blair Corp. to sell a business unit to Alliance Data Systems (see Opportunity Partners above).</li> <li>• Launched a proxy contest against Spartan Stores, although Loeb nominees withdrew due to increased stock price.</li> </ul>
K Capital	<ul style="list-style-type: none"> <li>• Launched proxy contest at OfficeMax. Contest was settled when the company agreed to appoint an independent director to the board, giving consideration to a director proposed by K Capital. The company also replaced its CEO. Case seemed settled at that point. However, on 11/14 K Capital sent a letter to the board asking them to declassify the board, remove pill, and restore shareholder right to call special meeting. In mid-January 2006, the company announced a “turn-around” plan, agreed to declassify its board at next shareholder meeting, and agreed not to renew its pill when it expires.</li> </ul>

Hedge Fund	Corporate Action
Jana Partners	<ul style="list-style-type: none"> <li>• Forced Deutsche Bourse to withdraw its bid for the London Stock Exchange, ousted its CEO, and forced the company to issue a special dividend to shareholders.</li> <li>• Worked with Carl Icahn to force Kerr-McGee to implement a share buy back program.</li> <li>• Called off proxy fight with SOURCECORP, Inc. after company agreed to nominate a Jana director to the board.</li> </ul>
Crescendo Partners	<ul style="list-style-type: none"> <li>• Thwarted Computer Horizon's merger with Analyst International and replaced the board with five of its own directors.</li> </ul>

**Traditional Defensive Strategies Employed By Corporate Issuers**

Most companies are willing to negotiate with a large shareholder not satisfied with the strategic direction of the company. As indicated, many impending proxy battles are settled before they even become public. But even when proxy contests do become public, negotiating with the dissident is frequently an effective way to settle the dispute if management believes it may have trouble winning the battle.

Keeping an open line of communication to a company's shareholders is one of the basic tenants of good corporate governance. A company involved in a proxy fight should not be seen as unwilling to meet with and discuss the issues with a dissident. However, companies must keep in mind that when a proxy contest is in full swing, negotiations usually result in a settlement with the dissident. The settle-

ment could involve minority board representation for the dissident or a pledge by the company to seek a buyer. Prior to a dispute with a shareholder, companies generally have some preemptive anti-takeover devices in their bylaws (discussed below). These devices are not perceived as favorable by corporate governance experts and institutional investors. It is strongly recommended that companies do not adopt any of these devices during a potential proxy contest as it would surely alienate many, if not most, institutional investors.

The most popular anti-takeover devices are:

1. **Shareholder rights plan, (also known as a poison pill):** Poison pills remain a favorite anti-takeover device of companies. In fact, some companies argue that having a poison pill forces potential acquirers to make a higher offer than if the company did not have a pill. The

anti-pill camp argues that it is impossible to know how many deals are not brought forward because the company has a pill in place.

Companies need to think carefully about whether to adopt a poison pill or not. Poison pills have come under increased scrutiny from corporate governance gurus and institutional investors. The independent proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis, do not support poison pills unless the pill meets strict criteria. To gain ISS support, a management sponsored poison pill proposal must have all of the following provisions:

1. 20 percent or higher trigger threshold;
2. No more than a 3 year term (updated for the 2006 proxy season);
3. No dead-hand provision (a pill provision that allows only the incumbent directors to remove the pill);
4. Shareholder redemption feature (if there is a bona fide offer for the company that is endorsed by management, the pill will be rescinded).

ISS will recommend withholding votes from the board of directors if the company adopts a new pill or renews an existing pill without shareholder approval since the company's last annual meeting. Proposals brought by shareholders that request a company to redeem a poison pill or submit it to a share-

holder vote are routinely supported by the institutional community.

2. **Classified board of directors:** Classified boards are the most common anti-takeover device but are not supported by the proxy advisory firms or many institutional investors. Proposals to declassify the board that are put forward by shareholders enjoy large support and it is rare when such a proposal does not get support from shareholders.

3. **Dual-class capitalization structure:** Companies with a dual-class capitalization structure have two classes of stock, often with different voting rights. For example, they may have a class A stock with one vote per share and a class B stock with 10 votes per share. The supervoting class of stock is generally in the hands of company insiders or parties friendly to management. The net effect is that company management will always have the votes they need to support or defeat any proposal that may come up.

Again, the institutional community does not support any dual-class capitalization structure that they perceive as insulating management from accountability to shareholders.

4. **Eliminating or restricting written consent / special meeting:** The ability for shareholders to act by written consent or call a share-

holder meeting is dictated by state law and the corporation's bylaws. Acting by written consent provides a shareholder with more control over the timing and process than adhering to a company's schedule for a shareholder meeting. However, in a contested consent solicitation for board seats the hurdle for success is higher — the dissident needs the support of a majority of shares outstanding, rather than a plurality as is the case in a proxy contest.

Under a special meeting, shareholders who satisfy a minimum holding criterion can call a meeting that falls outside the company's normal meeting schedule to vote on certain material matters. For example, a potential acquirer could call a special meeting to have shareholders vote on a dissident slate of directors. Having the ability to act by written consent and call a special meeting is considered good corporate governance. When faced with a potential threat, companies may sometimes eliminate both of these rights.

Again, the institutional community does not support proposals to restrict or eliminate a shareholder's ability to act by written consent or call a special meeting.

### **Proxy Advisory Firms and their impact and policy on proxy contests**

**T**here are three major proxy advisory firms: Institutional Shareholder Services (ISS), Glass Lewis, and Proxy Governance.

**Glass Lewis**, ISS's main competitor, was founded in 2003. Glass Lewis provides analyses on 8,000 companies in more than fifty countries worldwide. Although they do not disclose the number of clients that use their service, they do state that their clients manage over \$8 trillion. Their research team is led by Lynn Turner, a former Chief Accountant with the SEC. On July 18, 2005, the company hired Robert McCormick, former Director of Investment Proxy Research for Fidelity Management and Research Co. Look for Glass Lewis to continue to grow and become a bigger presence in the corporate governance arena.

**Proxy Governance**, a subsidiary of FLOfn, Inc., is the "new kid on the block" and just completed its first proxy season in 2005. Therefore, it is still too early to determine the impact they may have, or to predict how they will fare.

**ISS** is the largest of the proxy advisory firms and, as noted above, recently acquired IRRC, one of its smaller competitors. ISS's main business is to provide proxy analysis, recommendations, and vote execution services to its institutional client base. Its other services include the Corporate Governance Quotient (CGQ) rating system and advisory work to a large group of corporate issuer clients. According to its website, it currently has close to 400 employees worldwide serving approximately 1,300 clients worldwide and it provides recommendations and voting on 33,000 companies worldwide. Approximately half of the ISS employees are dedicated to producing the analyses that go to their institutional client base.

How much impact do the proxy advisory firms have on a given shareholder meeting? It is impossible to answer this ques-

tion from a general perspective, as there are many factors that go into a shareholder vote.

First and foremost is a company's shareholder profile. Obviously, companies with large insider holdings or a modest institutional presence will not be as impacted by the vote recommendations. Also, for companies with a large institutional base, it is critical to know which of the large holders are impacted by the third party recommendations. An institution, for example, that follows ISS on executive compensation proposals may look more closely at a contest for board control. However, it is not uncommon to see the ISS analysis influence 20 to and 25 percent of the vote at a contested meeting.

There are two other points to factor into any impact analysis:

1. ISS and the other proxy advisory firms are just that - advisory firms. They make recommendations to their institutional clients but the final fiduciary responsibility lies with the institutions. These institutions can and do override the recommendations when they feel it is in their beneficiary's best interest. Those issuers that reach out to their investors can certainly have an effect on how their shareholders vote.
2. In the current corporate governance environment, there is increased scrutiny of corporate issuers and there are additional disclosure requirements for institutional investors. Many institutional investors have developed their own internal proxy voting guidelines as opposed to following the standard proxy voting guidelines of the advisory

firms. This is a good example of why it is important for corporations to identify who their shareholders are, initiate and maintain ongoing personal contact with large owners, and learn what polices these firms use to vote their proxies.

How do the advisory firms look at proxy fights when there is a contested election of directors?

A proxy contest for board seats is probably the most complicated and subjective proxy issue that proxy advisors will analyze. For example, ISS will assign one "lead" analyst, but a group of senior analysts will also review the material and weigh in with their own view of the contest. ISS also tries to meet, in person or on the phone, with both parties and give them a chance to present why they should recommend institutions vote for their slate of nominees.

In analyzing the slates for a proxy contest, the advisory firms consider the following factors:

1. **Company performance:** Has the company outperformed its peers? What are the reasons if the company's performance has been poor? Are the reasons industry specific or company specific?
2. **Business strategy:** What is the company's forward looking business strategy? If the stock price has been depressed, what strategies and steps has the company taken to turn this around? What is the business strategy of the dissident? What are the dissident's long-term objectives for the company?
3. **Director independence:** Are the

management and dissident nominees independent? Will there be a potential conflict of interest where a director's business interest may cloud his/her judgment and responsibility as a director?

4. **Director experience:** What are the backgrounds and experience of the proposed slates of directors? What skills and fresh insights will the directors bring to the company? For example, if the target company is a bank, do the proposed directors have experience in the banking industry?
5. **Background of the contest:** Does the company have a history of rebuffing potential takeovers? Has the company previously negotiated with the dissident?
6. **Corporate governance:** What does the corporate governance profile of the company look like? What corporate governance changes are the dissidents asking for? Is there evidence of management entrenchment?

Institutions will also take into consideration the scope of the proxy contest. Specifically, are the dissidents asking for total board control or board representation (replacing a few directors with their own)? If the dissidents are asking for a board change they will need to lay out specific business, strategy, and transition plans. The plans must contain specific financial, procedural, and operational targets. The dissident should propose a highly qualified management team if it is seeking shareholder support. In seeking board representation, the dissidents merely have to prove they would add value to board discussions and offer fresh insights for the company, not necessarily have intimate

knowledge of the company's operations.

### **Conclusion**

There is no doubt that hedge fund activism will continue to increase as investors continue to demand high returns for the fees they pay to hedge fund managers. It is also assured that hedge funds will continue to demand strategic, financial, and corporate governance changes from the companies in which they invest. If these demands do not meet the fund's expectations, they may launch proxy contests to affect change at the company.

In this environment, corporations and their advisors should identify who their "real" shareholders are, the type of holder they are, and understand how these parties vote on certain issues. It is imperative that corporations keep an open line of communication with their shareholders, both passive and active holders. Finally, corporations should insure they meet corporate governance best practices. This helps to minimize risk and provide a company with more protection from activist shareholders.

**About The Altman Group:** The Altman Group is one of the premier proxy solicitation corporate governance, shareholder identification, and bankruptcy services firms in the United States and winner of the 2006 TOPS Award as the Highest Rated Proxy Solicitation Firm.

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